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Equitable Subordination of Non-Insider Claims

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Equitable subordination is one of the most extraordinary powers granted to bankruptcy courts. Bankruptcy Code Section 510(c) allows the court to re-prioritize a claim in bankruptcy on account of inequitable conduct by the claimant, thereby placing part or all of a wrongdoer's claim—secured or unsecured—in an inferior status relative to other creditors. Equitable subordination under section 510(c) is designed to “undo or offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.”^[1]

However, equitable subordination is an extreme remedy that should be used sparingly and only in egregious circumstances. Indeed, the United States Supreme Court has admonished that equitable subordination may not be used as a categorical abrogation of the general priority scheme provided for in the Bankruptcy Code.^[2]

Over the years, the threat (whether actual or perceived) of equitable subordination has influenced the actions of creditors, especially secured lenders dealing with a foundering borrower. Several cases have recognized that secured lenders have legitimate rights and powers in a default or workout situation—and that the prudent exercise of those powers should not prompt the equitable subordination of that creditor's claim should the borrower find its way into bankruptcy.^[3] Nonetheless, lenders and their counsel are cognizant of the equitable subordination risk, and it does influence their decisions.

The Ninth Circuit's recent decision in *Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)*, 471 F.3d 977 (9th Cir. 2006) should provide some comfort to most lenders. That case, discussed below, affords great protection to non-insider creditors in their dealings with a troubled company—even when the company fails and inflicts substantial losses on innocent people.

The Bases for Equitable Subordination

The three basic requirements for equitable subordination, first set forth in *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692 (5th Cir. 1977),^[4] are:

(1) a creditor engaged in inequitable conduct;

(2) that conduct injured other creditors or conferred an unfair advantage to the acting creditor; and

(3) the subordination of the acting creditor's claim is not otherwise inconsistent with the Bankruptcy Code.^[5]

The *Mobile Steel* test has found widespread acceptance throughout the country.^[6] Its language has proven flexible enough to address the gamut of creditors and creditor misconduct.^[7]

Equitable subordination is typically applied when a fiduciary misuses his position to the disadvantage of other creditors, a third party controls the debtor to the disadvantage of other creditors, or a third party actually defrauds other creditors.^[8] While equitable subordination is typically employed as a remedy for the wrongful conduct of insiders, it can also apply to non-insider creditors.^[9] The burden of proof for a non-insider is considerably higher, however, because courts generally are "reluctant to find the requisite level of misconduct in arms-length transactions."^[10]

The *First Alliance* Decision

In re First Alliance Mortgage Co., highlights the high burden required to equitably subordinate the claims of a non-insider creditor. In that case, the debtor, First Alliance Mortgage Company (First Alliance), was a sub-prime mortgage lender focusing primarily on elderly individuals with high amounts of equity in their homes but little cash or other assets. First Alliance used a number of secondary lenders to underwrite its mortgage products, including Lehman Commercial Paper, Inc. (Lehman).

In the late 1990s, First Alliance came under scrutiny for its coercive and misrepresentative lending practices. In 1998, seven states and the US Department of Justice launched an official investigation into First Alliance. A number of lawsuits were soon filed, including one by the AARP. In March 2000, *The New York Times* published a front-page article regarding the coercive lending practices of First Alliance and its relationship with various Wall Street investment banks, including Lehman. Later that month, First Alliance filed a voluntary petition under chapter 11 of the Bankruptcy Code.

Two lawsuits were filed against Lehman based on its role as the primary underwriter for First Alliance, both asserting that Lehman knew of First Alliance's fraudulent lending practices yet continued to underwrite its mortgages. The first suit was a class action filed by First Alliance's unsecured creditors accusing Lehman of aiding and abetting the fraud in violation of California law. The second suit was an adversary complaint filed by the liquidating trustee (trustee) to equitably subordinate Lehman's \$77 million secured claim filed in the First Alliance bankruptcy case.

Both lawsuits were tried in the United States District Court for the Central District of California. In the class action lawsuit, the jury found Lehman liable for 10 percent of the total fraud damages suffered by the class, equal to roughly \$5 million. Because equitable subordination under section 501(c) presents an issue of law, the court – not the jury – determines the viability of that claim. Accordingly, the *First Alliance* judge held that equitable subordination was not an appropriate remedy in this case, reasoning that Lehman's conduct was not "sufficiently egregious to justify equitable subordination of a non-insider, non-fiduciary creditor."^[11] In reaching that conclusion, the district court stated that "[w]hile courts commonly discuss the level of non-insider, non-fiduciary conduct sufficient to warrant equitable subordination, that standard is rarely if ever met."^[12]

On appeal, the Ninth Circuit affirmed the district court's ruling.^[13] The court focused on the first *Mobile Steel* requirement—whether Lehman engaged in inequitable conduct. The court acknowledged that “[a]t first blush, the Trustee’s argument has a certain allure, because there is surely something ‘inequitable’ in an abstract sense about aiding and abetting fraud.”^[14] But the court agreed with the reasoning of the district court, stating: “Lehman’s activities were not carried out in contemplation of the later-filed First Alliance bankruptcy, and Lehman’s conduct was not a contributing factor to bring about the bankruptcy or determining the ordering of creditors to the bankruptcy estate. . . . Instead, the impact of Lehman’s conduct on First Alliance borrower creditors is only tangentially related to the First Alliance bankruptcy in that both Lehman and the borrowers are creditors of the First Alliance estate.”^[15] Accordingly, Lehman’s \$77 million secured claim was allowed despite Lehman’s alleged involvement in aiding and abetting First Alliance in its decidedly fraudulent lending practices.

The Impact of *First Alliance*

First Alliance highlights the different levels of scrutiny a court will apply when determining whether equitable subordination is appropriate.^[16]

Generally, with an insider creditor, the proponent need only make an initial showing of substantial impropriety, at which point the burden shifts to the insider to prove good faith and fair dealing.^[17] On the other hand, with a non-insider creditor, the proponent of equitable subordination carries the entire burden of proving that the conduct of the creditor was gross, egregious, and shocking to the conscious of the court.^[18] The considerably higher burden applied to non-insider creditors is due to their perceived lack of influence on and control over the debtor, and thus presumes the existence of fair, arms-length dealing.

Accordingly, when litigating an equitable subordination claim, the battle is really won or lost when defining the relationship between the creditor and the debtor.^[19] Furthermore, as the *First Alliance* decision highlights, non-insider creditors are provided significantly more latitude than insider creditors in their pre-bankruptcy interactions with the debtor.

For the most part, institutional lenders will not be considered insiders. Thus, courts should follow *First Alliance* and give those creditors, especially secured lenders, great latitude when evaluating equitable subordination claims. Perhaps most important to lenders is the Ninth Circuit’s endorsement that, while many equitable subordination claims are filed against non-insiders, the non-insider lender’s conduct is “rarely if ever” sufficiently egregious to support a claim for equitable subordination.

^[1] *In re Kreisler*, 331 B.R. 364, 380 (N.D. Ill. 2005).

^[2] *See United States v. Nolan*, 517 U.S. 535 (1996).

^[3] *See generally Waslow v. MNC Commercial Corp. (In re M. Paolella & Sons, Inc.)*, 161 B.R. 107, 119-21 (E.D. Pa. 1993) (listing cases); *Ralph v. Stock Yards Bank & Trust Co. (In re Kentuckiana Truck & Trailer Repair, Inc.)*, 291 B.R. 84, 95 (Bankr. W.D. Ky. 2002) (finding no “gross misconduct” by a non-insider lender to justify equitable subordination); *Salisbury v. Texas Commerce Bank-Houston, N.A. (In re WCC Holding Corp.)*, 171 B.R. 972, 987-88 (Bankr. N.D. Tex. 1994) (“Danger exists only when the lender exerts actual control over the borrower or when the lender-borrower relationship is close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings

between parties.”).

[4] Although *Mobile Steel* was decided under the old Bankruptcy Act, the requirements established by this decision remain good law under the Bankruptcy Code today. See, e.g., *Nolan*, 517 U.S. at 539 (“The District Courts and Courts of Appeals have generally followed the *Mobile Steel* formulation”) (citing *In re Baker & Getty Fin. Serv., Inc.*, 974 F.2d 712, 717 (6th Cir. 1992)).

[5] See *id.* at 700.

[6] See, e.g., *First Nat’l Bank of Barnesville v. Rafoth (In re Baker & Getty Fin. Serv.)*, 974 F.2d 712, 717-18 (6th Cir. 1992) (“Most courts have uniformly followed and applied the *Mobile Steel* test.”).

[7] See, e.g., *The Official Comm. of Unsecured Creditors v. DVI Business Credit, Inc. (In re DVI, Inc.)*, 326 B.R. 301, 310 (Bankr. D. Del. 2005) (“Section 510(c) of the Bankruptcy Code gives bankruptcy courts broad equitable powers to subordinate a claim on equitable grounds.”).

[8] See *United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (Matter of United States Abatement Corp.)*, 39 F.3d 556, 561 (5th Cir. 1994).

[9] While the term “insider” is defined under Section 101(31) of the Bankruptcy Code, it is often a highly fact-sensitive inquiry. See *Liberty Mut. Ins. Co. v. Leroy Holding Co., Inc.*, 226 B.R. 746, 755 (N.D.N.Y. 1998).

[10] *Capital Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (In re 604 Columbus Ave. Realty Trust)*, 968 F.2d 1332, 1361 (1st Cir. 1992).

[11] *Austin v. Chisick (In re First Alliance Mortgage Co.)*, 298 B.R. 652, 668 (C.D. Cal. 2003).

[12] *Id.* at 667.

[13] *In re First Alliance Mortgage Co.*, 471 F.3d at 1006-07.

[14] *Id.* at 1007.

[15] *Id.*

[16] *Aluminum Mills Corp. v. Citicorp North America, Inc. (In re Aluminum Mills Corp.)*, 132 B.R. 869, 894 (Bankr. N.D. Ill. 1991) (“The quality of conduct considered to be ‘inequitable’ under § 510(c) depends on the nature of the legal relationship between the creditor and the debtor.”).

[17] See, e.g., *In re Mr. R’s Prepared Foods, Inc.*, 251 B.R. 24, 29 (Bankr. D. Conn. 2000).

[18] See, e.g., *Fabricators, Inc. v. Technical Fabricators, Inc. (Matter of Fabricators, Inc.)*, 926 F.2d 1458, 1465 (5th Cir. 1991).

[19] *Id.* (“whether a claimant is an insider of the debtor can be fundamentally important in an equitable subordination case in that it affects the standard of scrutiny the court will apply.”)